

The Next Leg Higher May Already Be Taking Shape

Thoughts on the Market

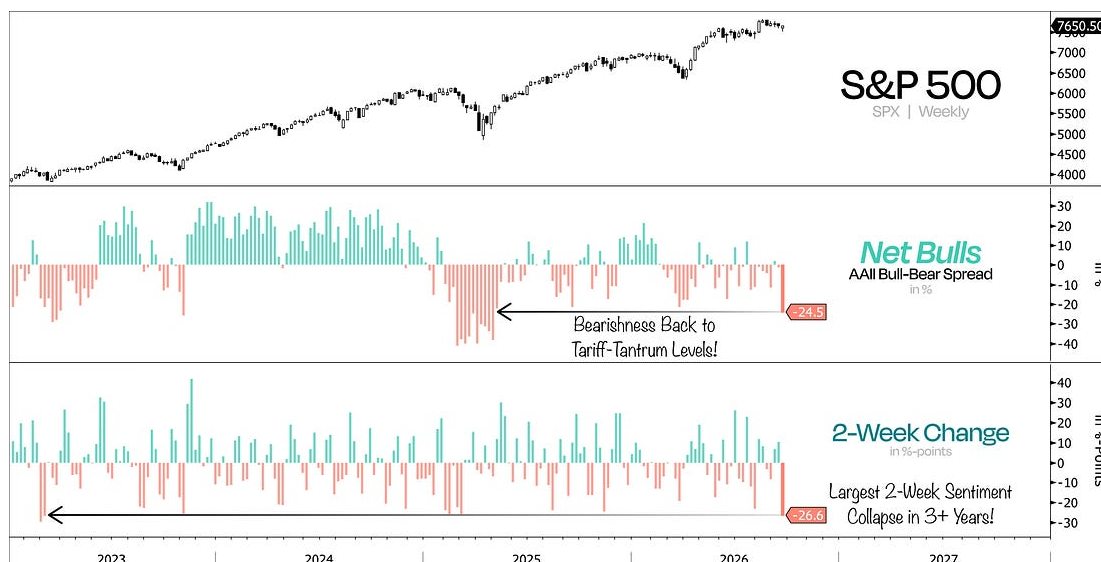


DUALITY RESEARCH

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After we highlighted last week how positioning among institutional investors had become **extremely light**, we now know that sentiment was telling a very similar story heading into the FOMC.

Net bulls had fallen by the most over any 2-week stretch in more than three years, pushing investor sentiment to its most bearish reading since the tariff tantrum in early 2025. In other words, investors weren't exactly walking into the Fed meeting with their chests out.



As we also said last week, this sort of setup usually results in relatively shallow pullbacks, simply because there isn't that much positioning left to unwind.

But more importantly, we don't think the Fed's overall message was nearly hawkish enough to spark the kind of selloff many investors may have feared heading into the meeting. In fact, we'd argue quite the opposite.

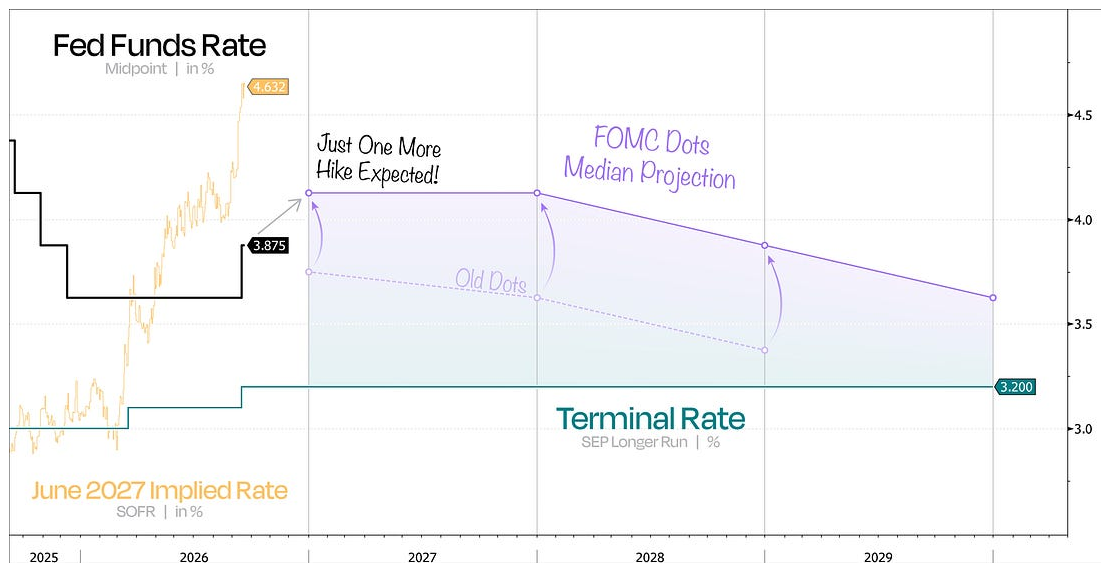
In our last note, we concluded that *"if the Fed signals that this is a **one-and-done** credibility hike, we should expect markets to keep marching higher,"* and that *"the real paradox may be that a Fed hike is what finally brings down the long end."*

Well... call it **two-and-done**.

That's certainly twice as many hikes as we expected, but the more important takeaway is that the Fed does **not** appear interested in embarking on a full-blown hiking cycle — something we had framed as the most bearish outcome for stocks.

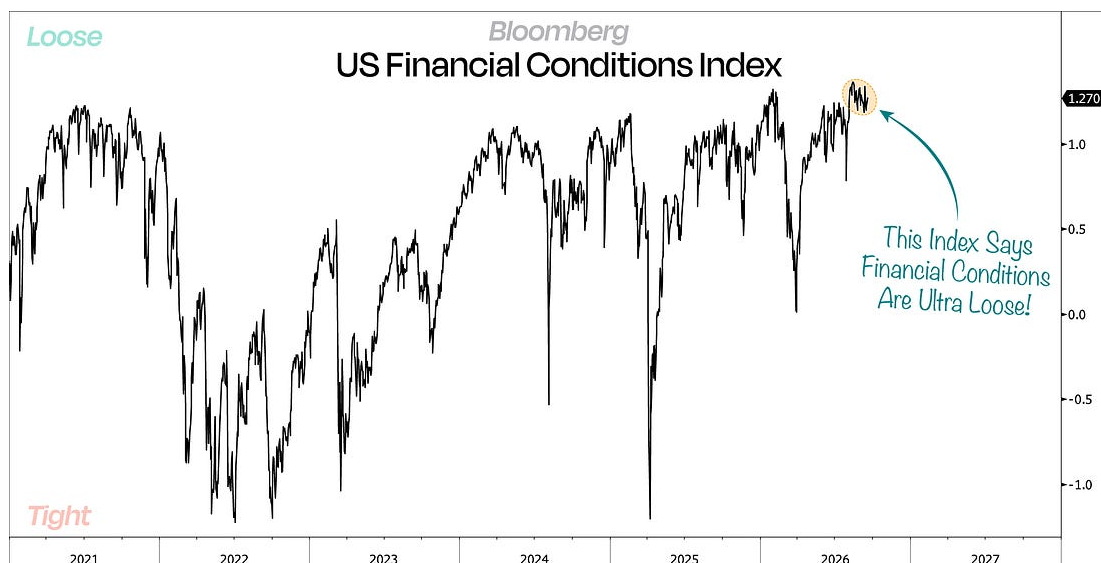
Our next chart shows this pretty clearly. Yes, the median dots moved higher. But after another hike this year, the Fed sees rates essentially holding steady throughout next year before gradually moving lower toward its *longer-run* rate, which was also bumped up to 3.2%.

Higher for longer? Sure. *A new hiking cycle?* That's not what the dots are telling us.



Now, despite this hike — *and likely another one* — we’ve come across plenty of takes arguing that with financial conditions currently *this loose*, there’s really only one direction left to go: **Tighter**.

And we understand where that thinking comes from. Take the *Bloomberg US Financial Conditions Index*, for example, and financial conditions do indeed look extremely loose.



The problem, however, is what actually goes into these indexes.

Typically, they also include equities and credit spreads, which creates a bit of a circularity problem. Stocks rally → financial conditions ease → and suddenly we conclude that easier financial conditions are bullish for stocks, even though the stock rally itself was partly responsible for that easing in the first place.

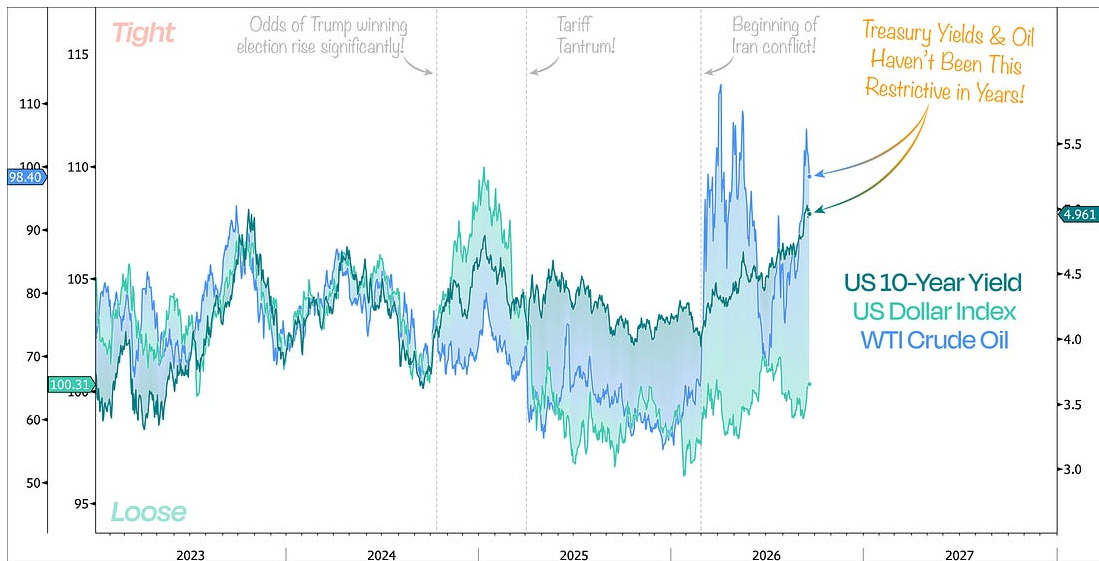
The same goes for credit spreads, especially *high-yield*, which are highly intertwined with equity risk appetite. When markets go risk-on, stocks rise and *high-yield* spreads tighten at the same time. Calling that an independent easing of financial conditions and then using it to explain why stocks are rallying gets us right back into the same circularity problem.

For us, financial conditions are essentially a function of interest rates, oil prices, and the US dollar. And through that lens, the picture looks quite different.

With perhaps the exception of the dollar, none of those are anywhere close to suggesting that financial conditions are *ultra-loose* right now. In fact, our next chart shows why we think the *asymmetry* here may actually be more interesting than the consensus narrative suggests.

Could financial conditions tighten further from here? Of course.

But they could also loosen **a lot** more from current levels — and if they do, that would provide a massive tailwind for risk assets. That's a possibility traditional financial conditions indexes don't make nearly as obvious, given they already suggest conditions are historically loose.



With investors lightly positioned heading into Q4, coupled with sentiment sitting at some of the most bearish levels we've ever seen with markets this close to all-time highs, we think the table is being set for a pretty decent year-end rally.

We have the conditions. Now we're just missing the spark.

And that spark, in our view, would be some combination of lower yields and lower oil prices.

What ultimately brings oil lower is fairly obvious. But when it comes to yields, we don't necessarily think we need oil to cooperate first. *Would lower oil prices help?* Absolutely. But with the Fed already showing that it's willing to hike in response to inflation, we think *that alone* could provide enough comfort for bond investors to start bidding Treasuries again.

In other words, we already think the pieces are in place for a move higher in stocks into year-end. So the bigger question, in our view, isn't necessarily ***whether*** equities move higher from here.

It's ***how far***.

And that may ultimately come down to oil.

If oil stays elevated, the rally probably has a lower ceiling.

If oil finally rolls over, that's when things could get a lot more interesting.

Having said all that, we believe it's time to revisit **Semiconductors** for a potential *high-beta* tactical trade into year-end.

Why now? Because after basically going nowhere for four months, the space appears to have gone through a pretty complete reset. The intense momentum unwind has taken much of the air out of the trade, sentiment has quite literally fallen apart, and valuations have become extremely undemanding.

Perhaps more importantly, though, nobody seems particularly interested anymore. The attention has shifted elsewhere, with many investors now chasing Software names instead. And that's where things get interesting.

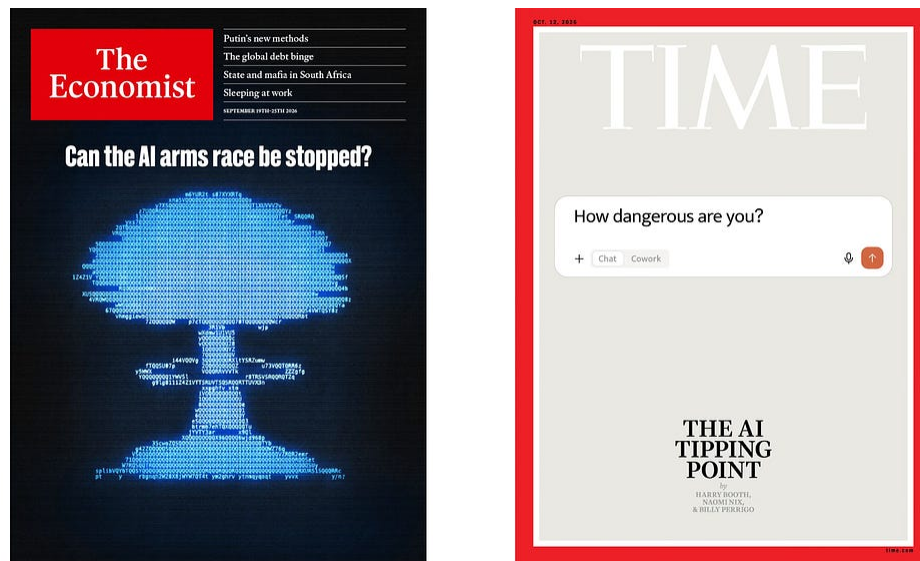
On our side, [we closed our tactical Software trade literally on the day the group marked its tactical top](#). Now, with investors seemingly lining up for Software while hardly anyone appears interested in picking up chip names, we think something may be brewing beneath the surface in Semis.

Four months ago, everyone wanted them. Today, almost nobody does.

That's usually when we start paying attention.

First off, some recent magazine covers from last week paint a pretty clear picture of the sentiment we're dealing with.

Doom and gloom is back *en vogue*. So, with everyone suddenly worried again that AI is about to eliminate us all, we'd say that pretty comfortably checks off the *fear* box.



Like we said before, four months of basically no gains has created a massive valuation reset, especially considering that forward earnings have continued to rise by roughly 40% over that same stretch.

And as our next chart shows, that has led to a pretty dramatic collapse in the relative valuation between Semis and the S&P 500.

A few things stand out here:

1. From 2010 up until the release of ChatGPT, Semis typically traded at a discount to the S&P 500, largely because of their more cyclical nature. Over that 13-year stretch, the average relative discount was roughly **12%**.

2. Since the launch of ChatGPT, that relationship completely changed. Semis began trading at a material premium to the broader market — something that rarely happened in the past.
3. Today, Semis are back to trading at a **13% discount** to the S&P 500. That's below the longer-run pre-AI average and marks the cheapest relative valuation in more than four years.

And that brings us to perhaps the most important part: **Semis are currently trading at just 16.6x forward earnings.**

We've heard plenty of arguments that the "E" in that equation is sitting in bubble territory — that earnings expectations have become overly optimistic and will eventually have to come down.

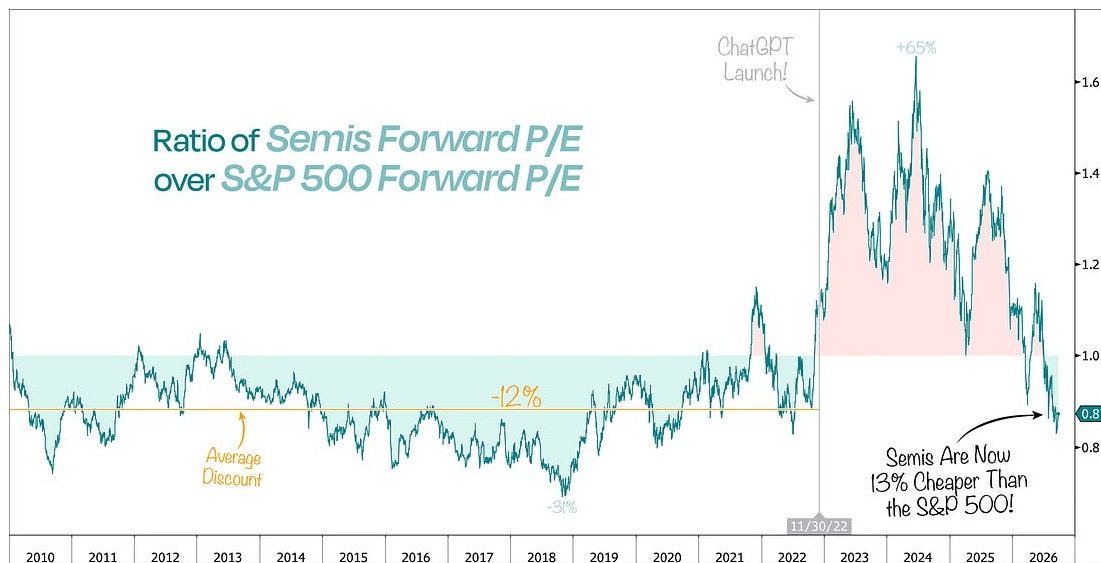
Maybe.

But if you're worried that the "**E**" is historically inflated, it's worth remembering what has happened to the "**P**."

It hasn't kept up.

And at just 16.6x forward earnings — coupled with a 13% discount to the broader market — we think the valuation already provides a pretty substantial cushion against the possibility that some of those forward estimates ultimately prove too optimistic.

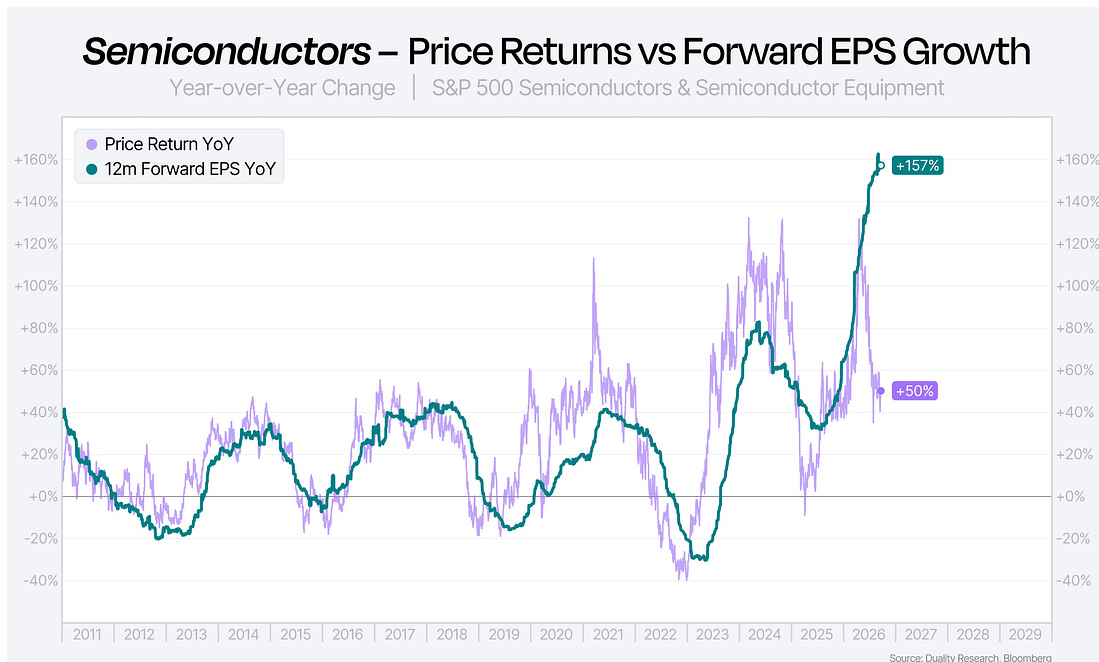
Put differently: **the "E" may be pricing in plenty of optimism, but the "P" certainly isn't.**



Another way to show just how skeptical **price** has remained about the sustainability of this **earnings** boom is by overlaying the *year-over-year* change in both. And our next chart tells quite the story.

Not only can we see the incredibly tight historical relationship between price and forward earnings, but we can also see the massive gap that has opened up between the two today.

While investors have remained cautious and refused to fully price in the earnings boom, Wall Street analysts have simply done their job of projecting future earnings. And despite how aggressive those upgrades may look on the chart, analysts have actually still been *too cautious*.



Now, here's where things get particularly interesting. Let's zoom in on that same chart, extend forward earnings based on current analyst estimates, and then make one very simple assumption: **Semiconductor prices go absolutely nowhere over the next 12 months.**

Under that scenario, *year-over-year* price growth would naturally converge toward zero, while forward earnings growth would still be hovering around **+40%**. That would essentially mean the massive disconnect between price and fundamentals we're seeing today would have to persist for another 12 months — something we think becomes increasingly unlikely if earnings continue to deliver.

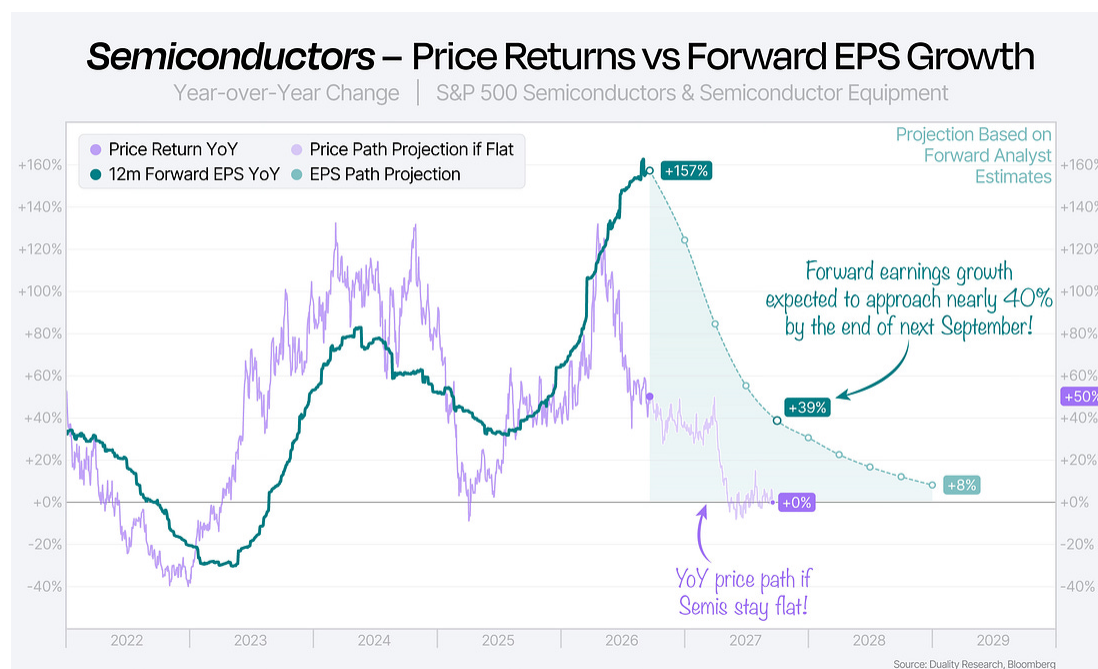
So ultimately, something has to give.

Either analysts are massively overestimating the earnings trajectory from here, or at some point price has quite a bit of catching up to do. Because if Semis really do trade sideways for another 12 months while the current earnings trajectory holds, the group would end up trading at **less than 12x forward earnings**. That would be an extraordinarily low

multiple for a group still delivering anything close to that kind of earnings growth.

For some perspective, assuming roughly 40% earnings growth over the next 12 months may sound aggressive, but we've effectively just witnessed that magnitude of forward earnings growth over the past ***four months***.

So yes, earnings estimates could disappoint. But if they don't, it becomes increasingly difficult to make the math work without price eventually doing some catching up.



So, where does that leave us?

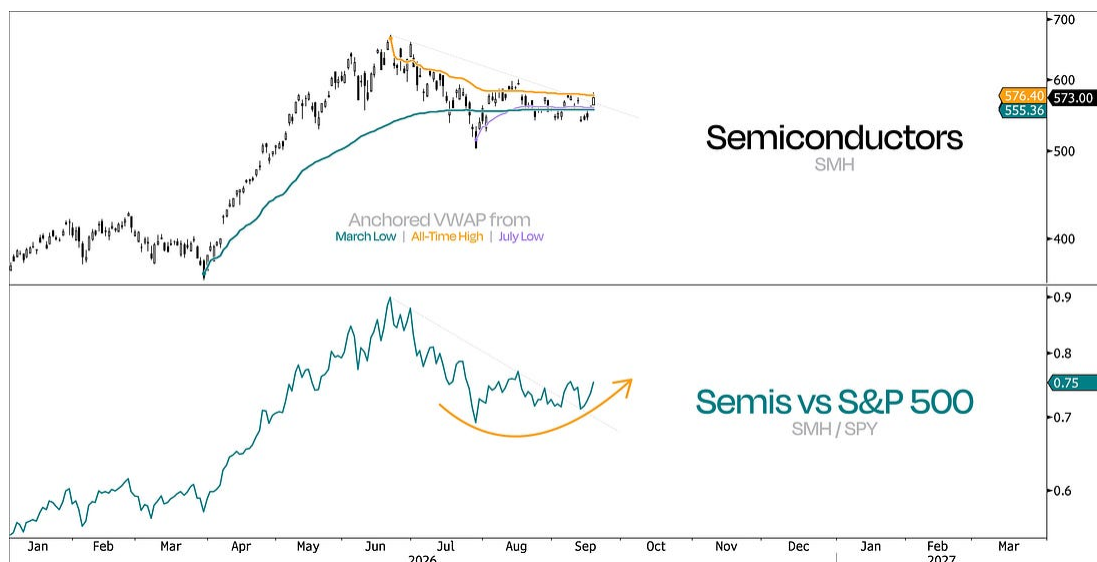
As we said, we believe the pieces are coming together for a potential year-end rally. And in anticipation of that, we think Semiconductors are increasingly well-positioned to potentially lead the market higher again into year-end.

Of course, the sentiment and valuation reset we described today only goes so far in explaining why Semis could catch a bid here. This is where **price and relative strength** need to close the gap and complete the picture.

And so far, they're starting to cooperate.

The [SMH ETF](#) has finally moved back above its anchored VWAPs from both the March lows and the summer selloff bottom. What's still missing is a decisive move back above the anchored VWAP from the all-time highs. At the same time, relative strength vs the broader market has managed to stabilize after bottoming in July and, so far, appears to be building a base.

In other words, the fundamental and sentiment setup is there. Now we're starting to see price catch on as well.

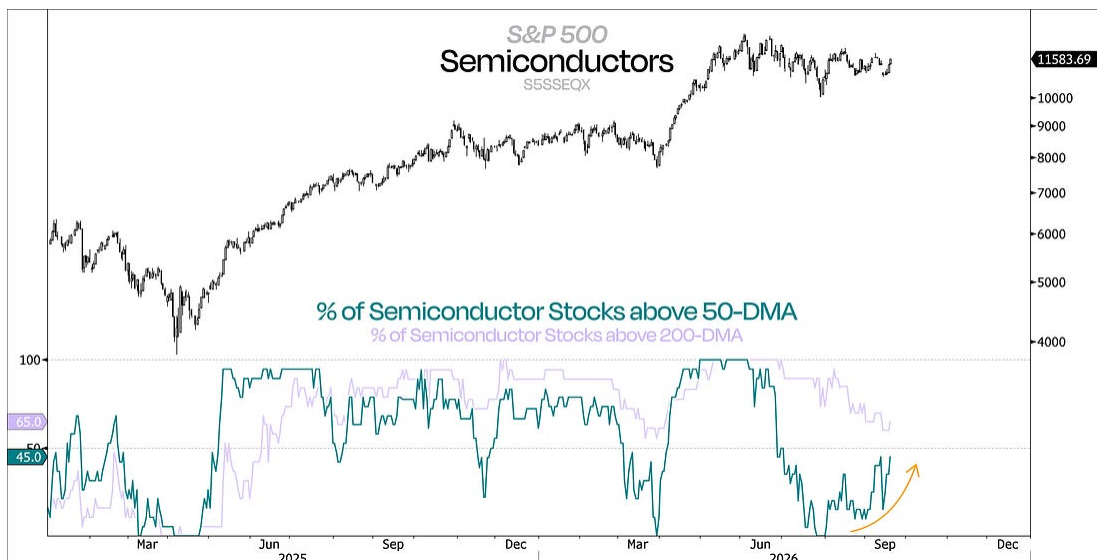


What's potentially signaling to us that both price and relative strength could start gaining momentum from here is what's already happening underneath the surface.

The percentage of Semiconductor stocks trading back above their 50-day moving average has been steadily improving since the summer lows. In other words, more and more chip names are moving back into short-term uptrends, while their longer-term trends never really suffered much damage in the first place.

That tells us the healing process from the recent reset — *which created those deeply oversold short-term conditions* — continues to move in the right direction.

The headline breakout may not be there just yet, but underneath the surface, more and more pieces are falling back into place.



For now, our job is simply to keep a close eye on how things evolve from here.

The setup is increasingly there: sentiment has been washed out, valuations have reset, breadth is healing, and price is beginning to cooperate. What we're still waiting for is that final bit of confirmation.

And if things continue to develop in the direction we're anticipating, we may very well have our next tactical trade on our hands.

Until then, we'll let the market do the talking.

Keep a close eye on your inbox in case we pull the trigger.

That's all for today. Thanks for reading! 🙌🧐
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